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IN THE

Supreme Court of the United States

OCTOBER TERM, 1978

No. 78-746

EVA GROSSMANN,

Petitioner,

vs.

EDWARD S. REDINGTON, Trustee, and SECURITIES INVESTOR PROTECTION CORPORATION,

Respondents.

RESPONDENT'S BRIEF IN OPPOSITION TO THE PETITION FOR A WRIT OF CERTIORARI

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RESPONDENT'S BRIEF IN OPPOSITION TO THE PETITION FOR A WRIT OF CERTIORARI

Preliminary Statement

This Brief is submitted by respondent Edward S. Redington, Esq., the Trustee appointed by order of the United States District Court for the Southern District of New York (the "Trustee") to liquidate the business of Weis Securities, Inc. ("Weis") pursuant to the Securities Investor Protection Act of 1970, 84 Stat. 1636, (formerly) 15 U.S.C. §§ 78aaa *et seq.* (1970) ("SIPA" or the "1970 Act")[1] in opposition to the petition for a writ of certiorari

1. The Securities Investor Protection Act was amended in important respects in 1978. Securities Investor Protection Act Amendments of 1978, Pub. L. No. 95-283, 92 Stat. 249 (1978) (to be codified in 15 U.S.C. §§ 78 aaa *et seq.*). As discussed at pages 8-9, *infra*, one effect of those amendments is to make clear that a claimant such as petitioner cannot obtain, by rescission or otherwise, the preferred status of a "customer" which petitioner seeks. Securities Investor Protection Act Amendments of 1978 § 15, 92 Stat. 271 (to be codified in 15 U.S.C. § 78 lll (3)(B)).

to review the decision of the United States Court of Appeals for the Second Circuit entered on June 12, 1978.

Counter-Statement of Question Presented

Whether, in the liquidation of a brokerage house under SIPA as it existed at the time of the Weis liquidation, where the brokerage house had been permitted by regulatory authorities to deal with the public on the strength of subordinated capital contributed pursuant to a statutorily required net capital rule designed to protect customers and ensure public confidence in broker-dealers in securities, individual reliance in fact by thousands of customers and creditors of the brokerage house on an approved lender's subordination agreements is a necessary element that must be proved to exist in spite of the net capital rule before a subordinated lender can be estopped from rescinding such an agreement and claiming preferential treatment as a "customer," to the detriment of genuine customers and other creditors of the brokerage house?

Counter-Statement of the Case

The decision below involves the type of treatment that should be afforded subordinated lenders who assert fraud or similar claims in brokerage house liquidations. Thanks to recent amendments to both the Bankruptcy Act and SIPA, this question is now entirely controlled by statute. See pages 8-9, *infra*. At the time of the Weis liquidation in 1973, SIPA provided that the term "customer" excluded persons whose claims involved subordinated loans or the return of property that had been "part of the capital of the debtor," SIPA § 6(c)(2)(A)(ii), (formerly) 15 U.S.C. § 78 fff (c)(2)(A)(ii) (1970), but did not specifically

address the rescission arguments advanced by the subordinated lenders in this liquidation.

Subordinated loans play a unique role in the financing and regulation of broker-dealers. The proceeds of such loans, once approved by regulatory authorities, are used as capital in the business of the broker-dealer and are counted as "net capital" in applying to the broker-dealer the net capital and other financial responsibility rules with which the broker-dealer must comply in order to continue doing business with the public. The circumstances under which loan proceeds may be used as "net capital" are defined and monitored by the New York Stock Exchange (the "Exchange") as part of the regulatory scheme enacted by Congress in the Securities Exchange Act of 1934 and administered by the Securities and Exchange Commission and the Exchange.[2] The key requirement is that the lender promise "irrevocably" to subordinate his claim for the return of property loaned to the claims of all other creditors.[3] Subordinated lenders generally receive high rates

2. Exchange Rule 325 governs net capital requirements for member firms. It was promulgated by the Exchange in its capacity as a self-regulatory authority under Section 6(d) of the Exchange Act, 15 U.S.C. § 78f(d), and was approved by the SEC on the theory that it was "more comprehensive" than the SEC's own net capital rule applicable to over-the-counter broker-dealers. The SEC rule also requires subordination of loans if they are to be counted as net capital and precludes rescission of subordination agreements "by mutual consent or otherwise," if rescission would cause the broker to exceed the required ratio. Rule 15c3-1d (c)(1), 17 C.F.R. § 240.15c3-1d(c)(1).

3. The prospective lender was required to submit a personal application for approval to the Exchange. Loan agreements had to be accompanied by an opinion of counsel stating that the subordination provisions were valid and enforceable, and the loan agreements became effective only upon Exchange approval of their terms; the required terms included not only the subordination provision but also limitations on premature withdrawal without Exchange consent or withdrawal even upon maturity when the broker-dealer was insolvent or in violation of the net capital rules. A copy of the agreement itself was required to be filed with the Exchange.

of interest in return for their investments.

Weis had over fifty subordinated lenders who contributed more than nineteen million dollars of capital to Weis. As would be the case with most broker-dealers, this capital constituted the bulk of Weis' "net capital" on the filing date.

The present litigation arose from the claims involving some twelve million dollars of twenty-three subordinated lenders who asserted that they could achieve the status of general creditors or even, as petitioner contends, be treated as customers[4] by rescinding their subordination agreements on the ground of fraud in the inducement. Most of these lenders alleged nondisclosure or misrepresentations of material facts relating to the financial condition of Weis in late 1972 and early 1973. These allegations were based on criminal indictments or informations returned against a small cadre of Weis officers who eventually were convicted for false reporting of Weis' financial condition.[5]

The Trustee moved for summary judgment against these rescission claims in the Bankruptcy Court on the ground that, even assuming that fraud or other possible grounds for rescission could be shown, the position of the lenders as contributors of subordinated net capital to Weis would make rescission inequitable as to the other creditors and customers of Weis. Under the Trustee's motion, the claims of the twenty-three lenders would be allowed in the Weis liquidation, but in a subordinated capacity. The issue

4. A "customer" receives preferential treatment under SIPA. Extending customer status to persons not entitled to such preferential treatment dilutes the amounts that can be distributed to other customers and to general creditors.

5. Mrs. Grossmann actually alleged a factually weaker case for rescission than was alleged by the other lenders. Mrs. Grossmann made her investment in 1967 and 1969, several years before any fraud is alleged to have occurred. Her investment yielded regular quarterly interest payments for nearly six years before it soured.

argued and decided below was whether reliance on the lenders' agreements by over 30,000 customers and nearly 2,000 other creditors would have to be proved as a fact in some way (thus making summary judgment inappropriate) before the lenders could be precluded from rescinding the subordination features of their agreements.

Bankruptcy Judge Babitt denied the Trustee's motion with respect to all the subordinated lenders opposing the Trustee's position. The Bankruptcy Judge interpreted dictum in a Second Circuit decision, *In re Credit Industrial Corp.*, 366 F.2d 402 (2d Cir. 1966) *("CIC")*, as requiring proof of reliance in fact in all cases despite the fact that the *CIC* case did not involve a regulated industry comparable to the securities industry.

The District Court (Wyatt, J.) reversed with respect to all subordinated lenders, including Mrs. Grossmann, in a thirteen page opinion. Judge Wyatt reasoned that the Second Circuit's statements in *CIC* were dictum which did not control in this liquidation. The District Court held that proof of reliance would either be unnecessary or that reliance could be presumed to exist in this regulated industry where the lenders' agreements permitted Weis to comply with net capital rules—a *sine qua non* for Weis' remaining in business. (A28.)

The Court of Appeals affirmed the opinion of the District Court in a sixteen page opinion. After distinguishing *CIC* (A8-A9), the court concluded that factual issues relating to individual reliance by customers were irrelevant in view of the congressionally-mandated regulatory scheme. The Court relied on a line of cases from the field of bank liquidations holding that contributors to the capital of banks must stand by undertakings that have satisfied regulatory requirements and allowed banks to do business with the public. (A9-A12.)

In addition to rejecting the right to rescind claimed by all the lenders, the Second Circuit treated separately, and rejected, a series of arguments raised on behalf of Mrs. Grossmann, including all the arguments raised in the petition.[6] On Mrs. Grossmann's argument for special treatment the court stated its conclusions as follows:

> "[Mrs. Grossmann] says that when she purchased 20,000 of Weis subordinated debentures she did not fully understand the benefits and risks of her investment. She concedes that she did know that her investment as a loan to Weis would return about the highest rate of interest of any investment she could make. At oral argument before us, her attorney acknowledged that she had received several thousand dollars in interest during the six years she had owned the debentures prior to the liquidation of Weis. She nevertheless argues that, because of her peculiar lack of sophistication, she never became a party to a subordinated debenture agreement; and that she actually was a general creditor or customer of Weis within the meaning of § 6(c)(2)(A)(ii) of SIPA. We find no merit in this contention and hold that there is no basis for treating Mrs. Grossmann any differently than the other lenders." (A13-14; footnote omitted.)

On Mrs. Grossmann's argument that a constructive trust should be imposed, the court held that no relief was possible because there was no *res* upon which a trust could be imposed. (A14-A15.) The opinion, of course, does not

6. Mrs. Grossman, whose maximum claim could only be for $20,000 less interest received, has had the good fortune to have been represented throughout these proceedings by the office of the Attorney General of the State of Illinois. The Attorney General's office has apparently become involved out of a general concern for defrauded citizens rather than from any particularized State interest. (Petition, p. 5.)

affect Mrs. Grossmann's rights under New York Stock Exchange Rules or the common law against Mr. Meiselman, the New York Stock Exchange or anyone else outside the Weis liquidation.

Petitions for rehearing filed on behalf of Mrs. Grossmann (A17) and one other lender were denied. Of all the Weis subordinated lenders, Mrs. Grossmann is the only one to have pursued the matter to this Court.

The Reasons For Denying The Petition

1. The Decision Below Was Correct.

The result of the decisions below is to allow Mrs. Grossmann's claim in the Weis liquidation but on a subordinated basis consistent with the terms of the subordinated debentures which she purchased in 1967 and 1969 in exchange for generous interest payments. The decision below does not deprive Mrs. Grossmann of rights that she may have outside of the Weis liquidation against Mr. Meiselman or others based on violations of New York Stock Exchange Rules or the law of Illinois. Its only effect is on the treatment of her claim *vis-a-vis* other persons with sympathic claims—unsubordinated creditors and customers in the Weis liquidation.

The decisions of both the Court of Appeals and the District Court with respect to all Weis' subordinated lenders, including Mrs. Grossmann, are eminently sensible and in accord with the prior decisions of this and other Courts. To prevent any future dispute about such issues, Congress has amended both the Bankruptcy Act and SIPA to ensure that precisely the result reached with respect to Mrs. Grossmann and the other lenders below will obtain in future liquidations. See Section 2, *infra*.

2. The Importance of the Question of Law Decided by the Second Circuit Has Been Vitiated by Recent Amendments to SIPA and the Bankruptcy Act.

Congress has recently amended SIPA specifically to prevent a subordinated lender fom being treated as a "customer", "notwithstanding that some ground exists for declaring [the lender's subordination] contract, agreement, or understanding void or voidable in a suit between the claimant and the debtor." Securities Investor Protection Act Amendments of 1978 § 15, 92 Stat. 271 (1978) (to be codified in 15 U.S.C. § 78 lll (3)(B)). Thus the arguments advanced on behalf of Mrs. Grossmann for customer treatment under the original SIPA will have no application to cases arising in future liquidations under the amended statute.

The limited impact of the issues raised on behalf of Mrs. Grossmann in future liquidations is further underscored by Section 510(b) of the new Bankruptcy Act signed by the President last month. Pub. L. No. 95-598, 92 Stat. 2549 (1978) (to be codified in 11 U.S.C. §§ 101 *et seq.*). Congress has made a policy judgment that the same result reached by the Second Circuit with respect to subordinated lenders in this regulated industry should apply to investors in all industries.

Section 510(b) provides:

> "(b) Any claim for rescission of a purchase or sale of a security of the debtor or of an affiliate or for damages arising from the purchase or sale of such a security shall be subordinated for purposes of distribution to all claims and interests that are senior or equal to the claim or interest represented by such security."

A "security" is defined by Section 101(35)(A)(v) to include "debentures" such as those purchased by Mrs. Grossmann.

These provisions will be applicable to future SIPC liquidations as well as to ordinary bankruptcies by virtue of the amended SIPA, which states that a SIPA liquidation shall be conducted "in accordance with, and as though it were being conducted under, the Bankruptcy Act." Securities Investor Protection Act Amendments of 1978 § 8, Pub. L. No. 95-283, 92 Stat. 259 (1978) (to be codified in 15 U.S.C. § 78fff (b)).

The principles applied by the courts below to Mrs. Grossmann's claim in this liquidation have been determined by the legislature to be the principles that will apply to all similar claims in all future liquidations. A decision on the issue by this Court is therefore unnecessary and would not affect the future development of the law.

3. The Decision Below Does Not Call for An Exercise of Supervisory Power By This Court.

There has never been serious dispute that rescission is precluded if third parties have relied on the promise which the rescinding party attempts to repudiate. The question below was whether reliance on the lenders' agreements by some or all of the 30,000 customers and nearly 2,000 general creditors of Weis had to be proved as a fact in order to preclude rescission. This hopeless burden would entail proof of the very antithesis of what Congress intended in subjecting brokerage houses to extensive financial regulation—that customers wishing to invest in the securities market be *relieved* of the burden of having to make sophisticated inquiries into an individual broker's finances. H.R.Rep. No. 1383, 73d Cong., 2d Sess. at 3 (1934).

Because any other decision would have destroyed the efficacy of the net capital rules, both the District Court and the Court of Appeals held that reliance could either be presumed to exist or that proof of this element could be dis-

pensed with as a matter of law because of the pattern of regulation that exists in this industry. (A12-A13; A28.) A principal issue below was the application of dictum in a prior Second Circuit case, *In re Credit Industrial Corp.*, 366 F.2d 402 (2d Cir. 1966), a case involving subordination agreements in an unregulated industry. The Second Circuit refused to extend this dictum to this heavily regulated industry in a senseless and inflexible manner that would have done violence to the net capital rule. (A8-A9, A13.) The Second Circuit's interpretation of its own prior statements is scarcely a question calling for review by this Court. Moreover, the Second Circuit's disposition of the matter has now been established as the law for the future by legislation.

4. The Decision Below Does Not Conflict with Decisions of This Court or Any Court of Appeals.

There is no conflict among the circuits, or between the decision below and the prior decisions of this Court, on the issues involved here. Quite the contrary, the holdings of the Court of Appeals and the District Court are consistent with the holdings of a long line of federal and state cases, including a series of decisions by this Court, insisting on strict enforcement of the obligations of defrauded lenders or shareholders in the liquidations of banks and insurance companies which have in the past been subject to comparable systems of regulation. *E.g.*, *Oppenheimer* v. *Harriman National Bank & Trust Co.*, 301 U.S. 206, 215 (1937); *Lantry* v. *Wallace*, 182 U.S. 536, 552-53 (1901); *Scott* v. *Deweese*, 181 U.S. 202 (1901); *Julian* v. *Stewart*, 56 F.2d 32 (5th Cir. 1932); *Anderson* v. *Cronkleton*, 32 F.2d 170 (8th Cir. 1929); *Hurd* v. *Kelly*, 78 N.Y. 588 (1879); 1A A. Corbin, *Contracts* §§ 197, 200 at 219-20 (1963).

5. The Decision Below Correctly Applied the Law to The Factual Assertions of Mrs. Grossmann.

The petition does not call into question any of the principles of law applied by the courts below. Rather, it wistfully argues that different rules should have been applied to Mrs. Grossmann because she was less "sophisticated" than the other lenders.

The record here does not disclose that any error of fact was made by the courts below with respect to Mrs. Grossmann, much less an error of such enormity that it requires consideration by this Court. Every conceivable argument for separate treatment for this one claimant was advanced below, including such points as the constructive trust argument renewed in the petition, arguments based on the factually inapposite Illinois Bulk Sales Act and arguments based on the Exchange's "know your customer rule" which has never been held to provide a right to relief in circumstances such as the present or to determine the enforceability of subordination agreements under SIPA. These arguments were all considered, and rejected, by the Court of Appeals (A13-A14).

Contrary to the principal contention urged by the Attorney General on behalf of Mrs. Grossmann, the facts recited in her affidavit in opposition to the Trustee's motion for summary judgment show that she did not misapprehend the essential nature of the investment. Mrs. Grossmann states in her affidavit that the Weis officer with whom she dealt "explained to me that this investment was like a loan to the company" (A73) and that

> "I thought at the time of the investment that these debentures were really nothing else but shares of stock in Weis, Voisin & Cannon, and that I owned stock in the company." (*Id.*)

At the time relevant to her claims, as now, SIPA defined the term customer to *exclude*

> ". . . any person to the extent that such person has a claim for property which by contract, agreement, or understanding, or by operation of law, is part of the capital of the debtor or is subordinated to the claims of creditors of the debtor." (SIPA Section 6(c)(2)(A)(ii), (formerly) 15 U.S.C. § 78fff(c)(2)(A)(ii) (1970).)

Mrs. Grossmann's own "understanding" was that her property would become part of "the capital of the debtor" rather than being entrusted to Weis to trade in shares of publicly traded companies. As the Second Circuit held (A13-A14), this was enough, even before the statute was amended, to prevent her from receiving "customer" status. *See, e.g., SEC* v. *F.O. Baroff Co.*, 497 F.2d 280 (2d Cir. 1974).

Conclusion

For the foregoing reasons, the petition for a writ of certiorari should be denied in all respects.

Dated: New York, New York
December 4, 1978

Respectfully submitted,

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